Statement of

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Chairman Kanjorski, Ranking Member Pryce, and Members of the Subcommittee, I appreciate the opportunity to speak to you today on behalf of the Council of Federal Home Loan Banks (Council) about the Federal Home Loan Banks (FHLBanks) and legislative proposals to reform regulation of the housing government-sponsored enterprises (GSEs). My name is John Price, and I am President and CEO of the Federal Home Loan Bank of Pittsburgh (FHLBank Pittsburgh).

Before I address the issues presented by today's hearing, I would like to give a brief overview of FHLBank Pittsburgh. One of the twelve FHLBanks, FHLBank Pittsburgh helps our 334 member/owner financial institutions meet the housing and community development credit needs of communities throughout Pennsylvania, Delaware and West Virginia, just as the other eleven FHLBanks provide similar service to over 8100 financial institutions across the country. At year-end 2006, FHLBank Pittsburgh had assets of $77 billion.

As a cooperative, FHLBank Pittsburgh is an active partner with our members as they serve individual consumers, affordable housing providers, homebuilders, small businesses, and local governments across their markets. Helping a first-time low income homebuyer experience the American Dream of homeownership through our First Front Door program, assisting thousands of families to secure decent and affordable housing through the Affordable Housing Program (AHP), providing thousands of employees at hundreds of small businesses an important boost through our Banking on Business program, and helping communities meet such pressing needs as water treatment repairs through our Community Lending Program or letters of credit are some of the results of this partnership.

At the outset I would like to commend you, Chairman Kanjorski, for your continued interest and strong support of the FHLBank System (System) , and your commitment to ensuring that the System operates in a safe and sound manner with the best corporate governance practices. Likewise, Ranking Member Pryce, I commend you for your commitment and hard work to ensure that all the GSEs have a truly world class regulator with the necessary powers to ensure that the GSEs fulfill their missions in a safe and sound fashion.

The Council, which represents all twelve FHLBanks, believes it is important to resolve the legislative uncertainty and is supportive of your efforts toward the creation of a strong independent regulator for the housing GSEs.

FHLBank Overview

The FHLBanks and their members are the largest source of residential mortgage and community development credit in the United States. The FHLBank System is comprised of twelve independently owned and operated regional FHLBanks, their 8,100 member financial institutions (federally insured savings associations, savings banks, commercial banks, credit unions, and insurance companies). The Office of Finance serves the FHLBanks by issuing debt on behalf of the twelve regional FHLBanks for which the FHLBanks share joint and several liability. The twelve FHLBanks use that debt to provide, as of the end of 2006, over $641 billion of outstanding loans, known as advances, to member institutions, serving virtually every community in America. The FHLBanks are overseen by an independent regulator, the Federal Housing Finance Board (Finance Board).

While the System operates under a congressional charter with a housing mission similar to Fannie Mae and Freddie Mac, the FHLBanks are fundamentally different in structure, business model and perspective from these institutions. No other housing GSE operates under the same decentralized, regional structure as the FHLBanks, or is structured as a cooperative, owned and controlled by its members. The System's member/owners are also its customers. As cooperatives:

- FHLBanks issue no publicly traded equity stock.

- FHLBanks' member-contributed capital, which capitalizes the Bank System, does not trade on any market and does not fluctuate in value.
- No FHLBank officer or director receives any stock options or any stock related compensation; thus there is no incentive to manage or manipulate earnings in order to reap the benefit of options.

As a result of the cooperative structure, the return on equity profile of the FHLBank System is far different from that of Fannie and Freddie, which, as publicly traded companies, face public stock holder demands for return on equity. Rates of return on FHLBank stock have approximated the fed funds rate, in the neighborhood of three to five percent in recent years, far below the return expected from publicly traded corporations. For many of the System's members, their largest single asset on their balance sheet is their FHLBank stock – making the FHLBank's safety and soundness and their continued access to their FHLBank of paramount importance.

Member institutions use the FHLBanks' advance programs to meet the housing, community and economic development lending needs of their local markets. The vast majority of our members are not large enough to access the broadest range of capital market options on their own. FHLBank advances are the only capital market access for many FHLBank members and serve as an important resource to deal with any possible future credit crunches. Advances are a reliable, accessible funding source available during all phases of the business cycle. This means that community credit needs can be met in any number of economic scenarios. It also means that FHLBank members are safer, from a regulatory perspective, than financial institutions would be without access to FHLBank funding programs.

The fact that FHLBank members can borrow at any time from their FHLBank allows them to be more active lenders in their communities. FHLBank members can also structure FHLBank funding in terms of maturity and conditions to meet strategic asset-liability management goals or to fund specific lending products.

In addition, the FHLBanks' mortgage purchase programs provide members, particularly smaller-sized institutions, a desirable secondary market alternative. The ability of FHLBanks to purchase mortgages is a very important aspect of the mission to provide liquidity to our member institutions and has allowed many of our smaller members to offer 30 year mortgage products for the first time. Each FHLBank is especially focused on the need to manage the risks associated with these programs in a sophisticated and safe fashion. While the FHLBanks may have differing views on how to best manage these mortgages, I believe most Banks recognize the need to develop, over time, appropriate risk transfer methods with respect to these programs.

FHLBanks represent the largest private sector source of grants supporting low income housing. FHLBank members also utilize the AHP to help thousands of low-income families obtain housing. FHLBank AHP contributions were approximately \$295 million in 2006, up from \$282 million in 2005, due to the increase in earnings for that year. As a direct result of this program the FHLBanks have awarded over \$2.5 billion to create more than 520,000 affordable housing units since 1990. I will address this program in greater detail later in my statement.

<u>Significant Past Legislation</u>: The FHLBanks were created in 1932 to support America's housing finance system through thrift institutions and insurance companies. Over the System's seventy-five year history, the Congress has taken an active role in defining the mission and structure of the System. Two critical pieces of legislation shaped today's FHLBanks:

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA)

- expanded membership to include commercial banks and credit unions with a demonstrated commitment to housing finance;
- created the System's Resolution Funding Corporation (REFCorp) assessment on FHLBank earnings;

- established the AHP through which each FHLBank sets aside 10 percent of net earnings annually for the support of affordable housing throughout the nation; and
- required FHLBanks to establish Community Investment Programs (CIP) for members to undertake community-oriented lending, including affordable housing.

Title VI of the Gramm-Leach-Bliley Act of 1999, sponsored by Chairman Kanjorski and Congressman Baker, established universal voluntary membership; provided for a permanent capital structure; expanded the types of collateral that community institutions can pledge to secure advances, and increased the independent corporate governance of each FHLBank.

These two pieces of legislation, combined with the performance of the FHLBanks in the marketplace and customer demand for FHLBank products, resulted in considerable growth over the last decade. As of December 31, 2006, the FHLBanks had combined total assets of $ 1 trillion compared to $241 billion a decade ago. This growth is a direct result of an increase of more than 2,800 members in the past 10 years to just over 8,100.

<u>SEC Registration Status and Return to Scheduled Combined Financial Reporting</u>: As of August 8, 2006, all twelve FHLBank SEC registrations were effective, and all have current financial reports on the SEC EDGAR database. On November 8, 2006, the 2005 Combined Financial Report for the Federal Home Loan Bank System was published, marking a major milestone in the System's return to scheduled combined financial reporting. It is expected that scheduled combined financial reporting will resume with the publication of the 2006 Combined Financial Report by March 31, 2007, and continue with subsequent quarterly reports for 2007.

FHLBank Affordable Housing Programs

I would like to go into greater detail about a central aspect of the FHLBanks' public mission, the AHP. Pursuant to FIRREA, each of the twelve FHLBanks is required by statute to contribute at least 10 percent of its previous year's net earnings to the AHP, subject to a minimum annual combined contribution by the twelve banks of $100 million. The statute requires AHP subsidies to be used to finance homeownership by families with incomes at or below 80 percent of the median area income, or to finance the purchase, construction, or rehabilitation of rental housing in which at least 20 percent of the units will be occupied by and affordable for families with incomes at or below 50 percent of the area median income. These subsidies may be in the form of grants or below-cost interest rates on advances from the FHLBank to member lenders.

AHP funds are awarded through a competitive application program run by each of the FHLBanks as well as through a homeownership set-aside program established by the Finance Board. Since its beginning, the AHP has resulted in the FHLBanks having awarded approximately $2.5 billion in grants through their members, making it the largest private source of affordable housing support in the nation.

A key strength of this program is the flexibility it provides to FHLBanks to adapt to differing community needs across the country. AHP can be used to support a wide array of affordable housing projects – rental and owner-occupied as well as single-family and multi-family units. Unlike some other programs, AHP can be used for both housing rehabilitation and new construction, and can be used to augment other sources of funding by filling in gaps.

As do all the FHLBanks, FHLBank Pittsburgh relies on the expertise of its Affordable Housing Advisory Council, a blue-ribbon group of housing experts from West Virginia, Pennsylvania and Delaware that advises our Community Investment Department and our Board of Directors in operating the AHP. Because the System's structure allows each FHLBank to respond to different regional needs, a variety of approaches can be developed. An example is this year's FHLBank Pittsburgh pilot Housing Rehabilitation Program (HRP) that will provide housing repair and rehabilitation assistance to homeowners earning 80 percent or less of the median family income for their area. Eligible uses of HRP funds include rehabilitation assistance in connection with the rehabilitation of an owner-occupied housing unit to be used as the household's primary residence.

Mr. Chairman, knowing of your particular interest in and leadership surrounding FHLBank efforts to support community development to complement our main mission of providing liquidity to members and supporting affordable housing, I wanted to take a brief moment to highlight what FHLBank Pittsburgh is doing in that regard. As an independently owned and operated cooperative, our approach may be somewhat different from other FHLBanks. One of the valuable aspects of the System's unique structure is that each FHLBank can develop programs that best meet its district's local and regional needs.

<u>Banking on Business Program (BOB)</u>: The BOB program helps eligible small businesses with start-up and expansion costs. Each BOB dollar the FHLBank contributes typically leverages an additional $6 in financial resources to small businesses in the region, thereby creating or retaining jobs and improving local communities. BOB offers recoverable assistance to be leveraged with member financing to help small businesses that need it most.

Since 2000, FHLBank Pittsburgh has funded more than $27.5 million in BOB funding to assist small businesses in our district, creating or retaining more than 3,821 jobs. Examples of these businesses include: Analytical Biological Services of Wilmington, Delaware, a testing lab that produces tissue membrane preparations for pharmaceutical companies in the drug discovery process; the Grace Dental Practice in Cabin Creek, WV; Expansion of Custom Processing Services, Inc., an air milling and particle size reduction company headquartered in Reading, PA, and Nazar Diesel of Jessup, PA, a diesel engine repair business. This year, we will be committing $7 million in new funds.

<u>Community Lending Program (CLP)</u>: Referred to as the Community Investment Program (CIP) by other FHLBanks, is an $825 million noncompetitive revolving loan

pool that offers loans to member financial institutions for community and economic development projects that create housing, improve business districts and strengthen neighborhoods. For example, CLP recently helped three northeastern Pennsylvania municipalities upgrade their public water and sewer systems with $8 million in flexible, low interest financing ensuring timely completion of the work at a reduced cost to taxpayers. System-wide, CIP lending since program inception totals over $44 billion, financing over 600,000 housing units and thousands of economic development projects

Blueprint Communities: FHLBank Pittsburgh, in cooperation with multiple partners, has developed *Blueprint Communities*, a neighborhood revitalization initiative that will serve as a catalyst for creating sustainable neighborhoods in Delaware, Pennsylvania and West Virginia. This community revitalization training emphasizes a team approach and will provide the educational component necessary for communities to begin developing long-term, comprehensive community plans. Launched in 2005, this program involved 22 urban and rural communities across Pennsylvania and is expanding to West Virginia this year and Delaware in 2008. In fact, the announcement of West Virginia's 10 participating communities took place earlier this morning.

Investments: FHLBanks regularly invest in housing agency bonds and other public finance investments. FHLBank Pittsburgh has invested in specialty community development and municipal financings. As with housing authority bonds, all of our investments are taxable rather than tax-exempt. Working either directly with the municipal authority or through securities dealers, FHLBank offers flexibility of terms not normally encountered in traditional underwritings.

Letters of Credit (LOC): FHLBank Pittsburgh's LOC product can be used to help members to improve the credit rating for tax-exempt housing bonds, taxable community lending and public finance transactions, including bond issues. Additionally, LOCs can be used by FHLBank members to secure municipal deposits.

LOCs have been used to help finance water filtration plants; assisted living, senior care and nursing home facilities; community centers; and health care facilities. Additional uses have been for economic development, downtown re-development, low to moderate income housing developments, and general housing needs.

With respect to FHLBank LOC's, I would like to briefly mention important tax legislation that will help local communities raise tax-exempt funds for infrastructure improvements, industrial development, public healthcare facilities, fire stations, water treatment facilities, long-term care for the elderly, schools and other important activities.

Introduced in the 109th Congress as HR. 5177 by Ways and Means Committee members Phil English and Sander Levin, the legislation which has not yet been introduced in the 110th Congress, amends Section 149 of the Internal Revenue Code (IRC) to add FHLBanks to the list of GSEs that can credit enhance tax-exempt municipal bonds. Fannie Mae, Freddie Mac, FHA, and VA have been permitted since 1984 under the IRC to issue these LOCs. At that time, the FHLBanks' mission did not include community and economic development (it was added by FIRREA in 1989), now it does.

This legislation would allow FHLBank member banks to assist municipalities, certain health care facilities, and institutions of higher learning in lowering their funding costs when issuing tax-exempt bonds. The bill would allow FHLBank LOCs to support these bonds without triggering the loss of the bonds' tax-exempt status.

In addition to the Council, the legislation is supported by the American Bankers Association, America's Community Bankers, the Independent Community Bankers of America, the Mortgage Bankers Association, the National Association of Homebuilders, National Association of Higher Educational Facilities Authorities, the National Council of Health Facilities Finance Authorities, the National League of Cities and the US Conference of Mayors.

I would also like to thank you, Mr. Chairman, Full Committee Ranking Member Bachus and Committee Members Baker, Gerlach, Gillmor, Jones, Pryce, and Scott for your strong support of this legislation. We look forward to working with you on this legislation in this Congress.

Key Elements for a Positive Future

The FHLBanks can best support and build upon our successful record with a strong, independent regulator, engaged corporate governance, and effective risk management.

Independent Regulator: Under our current regulatory regime, the Finance Board's primary duty is "to ensure that the FHLBanks operate in a financially safe and sound manner." Our current regulator already has the powers accorded to traditional federal banking regulators.

- The Finance Board is not limited by funding constraints or congressional appropriations processes in carrying out its responsibilities. Its funding is provided by assessments on the FHLBanks that are not subject to review or challenge by the FHLBanks.
- Finance Board regulations govern a broad range of FHLBanks' operations including advances pricing, risk management, capital plan approval, directors' responsibilities and new business activities.
- The Finance Board also collects and monitors financial and risk management data from the FHLBanks each month, performs ongoing reviews of all aspects of the FHLBanks' operations and conducts annual on-site examinations of all twelve FHLBanks.

The FHLBanks all believe that it is essential to maintain a strong, independent regulator with the resources and authority to ensure the FHLBanks' continued safety and soundness and mission achievement. This independence has been a key element in the long-term safe and sound track record of the FHLBanks.

Sound Corporate Governance: Finance Board regulations require the FHLBanks' boards of directors to fulfill today's corporate director duties. These include the responsibility to select and oversee management, ensure the establishment and maintenance of an adequate internal control system, the responsibility to adopt a risk management policy, a strategic business plan, a member products policy that details the FHLBank's credit and pricing policies, and the responsibility to approve the FHLBanks' annual operating and capital budgets and quarterly dividends.

In carrying out their responsibilities, the boards of directors typically establish and act through committees. Finance Board regulations require each FHLBank's board of directors to have an audit committee with very specific regulatory responsibilities, including direct oversight of the FHLBank's internal and external audit functions. The boards of directors also typically establish other committees to facilitate their oversight of management. Committees vary from FHLBank to FHLBank, but typically include risk management, credit policy, human resources, and housing and community development functions. The various elements of the FHLBanks' corporate governance structure result in boards of directors that are active, knowledgeable, engaged, and fully aware of their responsibilities.

On the issue of appointive directors for the FHLBanks, I would like to note that the Council has been very concerned about the lack of appointments. In fact, on October 2, 2006 the Chairs and Vice-Chairs of all twelve FHLBanks wrote the Finance Board urging that appointments be made. The Finance Board recently issued an interim final rule that institutes a formalized process for selecting and appointing directors to the FHLBanks that provides a significant role for each of the FHLBanks in the appointment process. The Council supports this rule and believes that it will improve the process for selecting appointed members for the boards of directors of the FHLBanks.

In order to deal with the current vacancies, the Finance Board's rule requires the boards of directors of the Banks to submit a list of eligible and qualified individuals to the Finance Board on or before March 31, 2007. At this time, the Boards of each of the twelve FHLBanks are actively engaged in the process of nominating candidates for these appointive directorships.

Risk Management: As one of twelve independent institutions, the FHLBank Pittsburgh is responsible for its own risk management activities. Our risk profile is guided by a number of regulatory factors common across the System. FHLBanks are subject to a minimum 4.0 capital-to-asset ratio as well as a risk-based capital requirement. The FHLBank minimizes credit risk by over-collateralizing advances, limiting investments to highly rated securities, and establishing appropriate risk sharing features for mortgage purchase programs. No FHLBank has ever suffered a credit loss on an advance to its members in its 75-year history.

One source of risk to the FHLBanks is interest rate risk. Each FHLBank uses sophisticated, high quality financial models to continually assess the magnitude of the risk to earnings and the estimated market value of equity and earnings from changes in interest rates, mortgage prepayment speeds, and other market variables. A part of this process does involve the use of various derivatives such as interest rate swaps. Derivative positions are marked to market on a regular basis and appropriate collateral is in place at all times. Financial management policies limit the use of derivatives to hedging only. Like all users of derivatives, the FHLBanks are governed by complex accounting rules required for these transactions.

Beyond the board-established policies which conservatively limit a FHLBank's risk profile, the cooperative structure of the FHLBanks eliminates many of the incentives a publicly traded company might have to raise its risk exposure in search of higher returns. The primary mission of the cooperative is to provide member institutions the funding and financial services they need to meet the credit needs of their communities.

At the same time, the FHLBank must generate an adequate dividend return to member shareholders that meets their opportunity cost of investing capital in a low risk enterprise.

Guiding Principles for Legislative Reform

The combination of active legislative oversight, an independent regulator, engaged boards of directors and extensive risk management tools has proven to be effective for the FHLBanks. The flexibility of the FHLBank model has allowed for adaptation over time in response to changing financial industry conditions and market environments.

Recognizing that there would be very serious legislative efforts to reform regulation of the GSEs and that there was a great likelihood that the Federal Home Loan Banks would be included in this legislation, in October 2003 the Council adopted "Guiding Principles" for legislative reform. With respect to the Federal Home Loan Banks, we believe that these same principles still hold true in the 110th Congress:

> **First,** it is critical that the legislation preserve the FHLBanks' mission of providing cost- effective funding to members for use in housing finance and community development; encouraging regional affordable housing programs, which creates housing opportunities for low- and moderate-income families; and supporting housing finance through advances and mortgage programs.

> **Second**, it is critical that the legislation provide for a strong, independent regulator. This regulator should be protected by Congress, as other bank regulatory agencies have been – such as OTS and OCC –from intervention by any other agency on policy, rulemaking, application, adjudicative and budget matters. The new regulator must be given all of the authority and regulatory tools necessary to ensure that FHLBank advance and mortgage programs can operate going forward in a safe and sound manner that is consistent with their mission.

Third, it is critical that the legislation preserve the role and function of the FHLBanks' Office of Finance. The legislation must ensure that neither the U.S. Treasury, nor the independent GSE regulatory unit, has the ability to impede or limit the FHLBanks' access to the capital markets without cause.

Fourth, it is critical that the legislation maintain the unique characteristics of the regional structure of the twelve FHLBanks and provide a regulatory structure designed to recognize these unique characteristics. The legislation should maintain the devolution of governance powers to the individual FHLBanks' boards of directors.

Beyond these principles, there are a few specific issues I would like to address with respect to H.R. 1461.

Deputy for Housing Mission Oversight – Possible Unintended Consequences for FHLBanks

The inclusion of the FHLBanks under the Deputy Director of FHERA for housing appeared in the Chairman's print shortly before the committee markup in the 109th Congress. As a result, this aspect of the legislation has not been the focus of any hearings, testimony, or input. We think that it certainly deserves close scrutiny.

The deputy for housing will be responsible for oversight over Fannie Mae's and Freddie Mac's "housing mission and goals" and oversight over "the housing mission" of the FHLBanks. Combining the housing mission oversight of the FHLBanks and Fannie Mae and Freddie Mac does not reflect the unique benefits of each and may, inadvertently create homogenized regulation and programs.

Just as FHLBank corporate operations and business models are totally different from Fannie and Freddie, the FHLBanks AHP and CIP programs are different. Our suggestion is that FHLBanks should be removed from this provision. If the Deputy for

Housing regulates the AHP and CIP, we are concerned that a national "one size fits all" approach could prevail. This would undermine one of the key strengths of the AHP, its flexibility and ability to serve housing needs in every region in the country.

FHLBank Involuntary Mergers Should Hinge on Safety and Soundness

Section 26 of the Federal Home Loan Bank Act (Bank Act) authorizes the regulator, "Whenever [it] finds that the efficient and economical accomplishment of the purposes of this chapter will be aided by such action.... Any Federal Home Loan Bank may be liquidated or reorganized [12 U.S.C. 1446]." Section 206 of H.R. 1461 would have amended section 26 of the Federal Home Loan Bank Act to provide explicit authority for the *voluntary* merger of FHLBanks and established a clear set of procedures and rights for all the stakeholders of the FHLBanks in liquidation resulting from safety and soundness problems in Subtitle C of Section 1 – Prompt Corrective Action (PCA). We support these provisions. However, the bill does not change the authority of the regulator to reorganize a Federal Home Loan Bank based simply on efficiency.

We would recommend that the committee amend Section 206 of HR 1461 to clarify that FHLBanks can only be subjected to *involuntary* reorganization for reasons related to safety and soundness under the GSE regulator's PCA authority. Any non-voluntary reorganization would have to be based upon a determination by the regulator that this drastic action is necessitated by the safety and soundness of a particular Bank or the safety and soundness of the system as a whole.

Additional Issues

The Council supports the elimination of director compensation caps that was included in the GSE reform legislation (H.R. 1461) passed by the House in the last Congress. In addition the Council supports Section 204 of H.R. 1461, which allows any two or more FHLBanks to establish a joint office for the purpose of performing functions for, or providing services to the Banks. The Council also supports the increase in the asset size for community financial institutions and the use of advances for community development activities that was included in Section 208 of H.R. 1461. Finally, in the event that the legislation does not provide for the appointment of independent directors, the Council believes that it is important from the perspective of good corporate governance to provide for a category of independent directors, including community interest directors, and a process for their selection.

Conclusion

The Council of Federal Home Loan Banks supports legislative efforts to achieve a world class regulator for the housing GSEs. From the point of view of the FHLBanks, we believe it is critical that such legislation preserve the mission of the FHLBanks, provide for a strong, independent regulator, preserve the funding for the FHLBank System and preserve the unique regional cooperative nature of the FHLBank System.

Mr. Chairman, thank you for the opportunity to address the Subcommittee on this important matter. I will be happy to answer questions at the appropriate time.